

Board of Governors of the Federal Reserve System

**REPORT ON THE AUDIT OF THE
FEDERAL RESERVE SYSTEM'S
ENFORCEMENT ACTIVITIES**



OFFICE OF INSPECTOR GENERAL



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

OFFICE OF INSPECTOR GENERAL

October 24, 1997

The Honorable Susan M. Phillips
Chairman
Committee on Supervisory and Regulatory Affairs

We are pleased to present our *Report on the Audit of the Federal Reserve System's Enforcement Activities* (A9613). We performed our audit to evaluate the economy and efficiency of the System's enforcement activities.

Overall, we found that the processing of individual enforcement activities was generally efficient and the System can expedite processing when required to meet special circumstances. We did, however, find opportunities to further improve processing efficiency, minimize duplication of effort, and strengthen the controls over the enforcement functions and associated resources. Our report recommends (1) eliminating redundant enforcement tracking systems Systemwide, (2) increasing the Reserve Banks' authority to process certain corrective supervisory actions, (3) updating policies and procedures, and (4) revising specific objectives for processing Suspicious Activity Reports including elimination of the Board staff's duplicative review.

The Director of the Division of Banking Supervision and Regulation and the General Counsel provided us with responses to our draft report. Appendix 2 contains the General Counsel's comments on recommendation 2. Appendix 3 contains the director's comments. Their responses indicate general agreement with our recommendation on processing authority. The director agreed with our recommendation to update enforcement policies and procedures and with parts of our other two recommendations. We will follow up on their actions to implement our recommendations and will report any exceptions as part of our future audit activities.

We are sending a copy of this report to each member of the Board and to selected staff. The report is available to the public and a summary will appear in our next semiannual report to the Congress. We are also making the report available on our internet web page at <http://www.ignet.gov/ignet>.

Sincerely,

A handwritten signature in dark ink, appearing to read "Brent L. Bowen", is positioned above the title "Inspector General".

Brent L Bowen

Inspector General

Enclosure

Board of Governors of the Federal Reserve System

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EXECUTIVE SUMMARY

Background

The Board of Governors of the Federal Reserve System (the Board) has primary responsibility for supervising and regulating all bank holding companies and their nonbank subsidiaries, state-chartered banks that are members of the Federal Reserve System (the System), and the U.S. operations of foreign banks (referred to as Foreign Banking Organizations, or FBOs). The Reserve Banks, acting under delegated authority from the Board, perform day-to-day supervisory activities: conducting on-site bank examinations and holding company inspections, monitoring commercial bank activities, and initiating enforcement activities that address safety and soundness issues. The Division of Banking Supervision and Regulation (BS&R) formulates banking supervisory policies and procedures, oversees the supervision and regulation work of Reserve Banks, and reviews supervisory actions the Reserve Banks take under delegated authority.

Audit Purpose and Results

We performed our audit to evaluate the economy and efficiency of the System's enforcement activities. We found that the processing of individual enforcement actions was generally efficient, that cooperation among various Board and Reserve Bank staffs was generally effective, and that the System can expedite processing when required to meet special circumstances. We did, however, identify areas where efficiency could be improved. The System has a variety of independent information systems which we believe the Director of BS&R should eliminate in favor of a management information system that would provide consistent enforcement information Systemwide. In addition, we believe the Board should give Reserve Banks more authority to process certain enforcement activities and reallocate staffing levels accordingly. We also believe the Director of BS&R should strengthen controls over the enforcement function and associated resources by updating enforcement policies, guidance, and procedures and more clearly defining the objectives for processing Suspicious Activity Reports.

The current enforcement process requires the participation of the Reserve Banks, BS&R's Enforcement Section, three other BS&R supervisory sections, the Division of Consumer and Community Affairs, and the Board's Legal Division; none of these entities has complete responsibility for the entire enforcement function. Our audit showed that lack of a central unit responsible for coordinating the System's enforcement activities contributed to several of the problems we identified. Because the Director of BS&R is taking action to reorganize the division, we are not making any structural recommendations at this time. His reorganization proposal, coupled with recent Boardwide budget initiatives, provides a good opportunity for the Board to address enforcement-related roles and responsibilities and ensure that the division's new structure encompasses all aspects of the enforcement function, including determining resource requirements, establishing program guidance, and providing program oversight.

Analysis of Comments

The Director of the Division of Banking Supervision and Regulation and the General Counsel provided us with responses to our draft report. Appendix 2 contains the General Counsel's comments on recommendation 2. Appendix 3 contains the director's comments. Their responses indicate general agreement with our recommendation on processing authority and the director agrees with our recommendation to update enforcement policies and procedures. The director agrees with parts of our other two recommendations. We will follow up on their actions to implement our recommendations and will report any exceptions as part of our future audit activities.

BACKGROUND

Overview

The Board of Governors of the Federal Reserve System (the Board) has primary responsibility for supervising and regulating all bank holding companies and their nonbank subsidiaries, state-chartered banks that are members of the Federal Reserve System (the System), and the U.S. operations of foreign banks (referred to as Foreign Banking Organizations, or FBOs). The Federal Reserve Banks and the Board's Division of Banking Supervision and Regulation (BS&R) each play a role in fulfilling this mission. The Reserve Banks, acting under delegated authority from the Board, perform day-to-day supervisory activities: conducting on-site bank examinations and holding company inspections, monitoring commercial bank activities, and initiating corrective supervisory actions that address safety and soundness issues.¹ BS&R formulates banking supervisory policies and procedures, oversees the work of Reserve Banks, and reviews supervisory actions the Reserve Banks take under delegated authority.

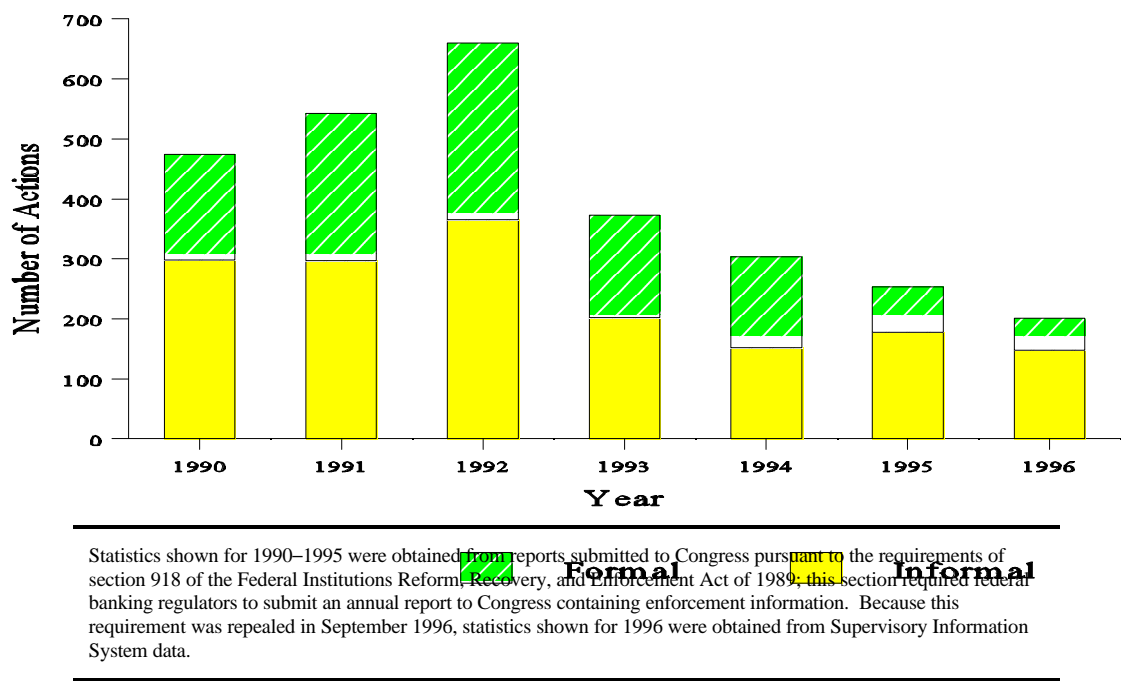
When an institution or affiliated individual does not comply with relevant laws and regulations or engages in activities that might affect the institution's safety and soundness, the Reserve Banks or the Board can take a corrective supervisory action to require the institution or individual to correct the problems. The Reserve Banks' informal supervisory actions include requesting an institution to adopt a board resolution or agree to the provisions of a commitment letter or memorandum of understanding (MOU). Although informal supervisory actions are designed to correct identified weaknesses, they are not enforceable as a matter of law. If the problems identified are more severe or if the informal actions are not effective, the Board may take a formal enforcement action to compel the management and directors of a troubled banking organization to address the problems. Under the Federal Deposit Insurance Act (FDI Act), as amended, the Board has the authority to enter into written agreements or cease-and-desist orders with state member banks, bank holding companies, and persons associated with these organizations; to assess civil money penalties for violations of a cease-and-desist order or violations of a law or regulation; or to remove an officer or director from office and, if necessary, permanently bar him or her from the banking industry.² Corrective supervisory actions generally require the financial institution or individual involved to report on progress in complying with the provisions of the action.

¹Given the various terms used when discussing enforcement activities, for purposes of this report we use the term "corrective supervisory action" to represent all types of actions the System may use to address problem areas, unsafe and unsound conditions, or violations of laws and regulations. Appendix 1 contains definitions of types of corrective supervisory actions as identified in the *Operating Assistance for the Supervisory Information System* manual.

²The FDI Act also gives the Board the authority to issue subpoenas and administer oaths and take depositions in connection with an examination or inspection. The International Banking Act of 1978, as amended by the Foreign Bank Supervision and Enforcement Act of 1991 (FBSEA), gives the Board the authority to initiate similar actions against branches and agencies of foreign banks. Other legislation, including the Financial Institutions Supervisory Act; Title IX of the Financial Institutions Reform, Recovery, and Enforcement Act; and the Comprehensive Thrift and Bank Fraud Act, has amended the FDI Act to supplement the Board's enforcement powers.

The System initiated 2,817 corrective supervisory actions during the period 1990 to 1996. Of this total, 42 percent were formal enforcement actions and 58 percent were informal supervisory actions. Although the mixture of actions has varied, figure 1 reflects the general downward trend in total actions the System has initiated since 1992.

Figure 1
System’s Formal and Informal Actions Initiated (1990–1996)



Board Staff Responsibilities

BS&R has primary staff responsibility for preparing and processing formal enforcement actions. Specifically, BS&R's Enforcement Section provides the Board with specialized legal advisory services relating to formal enforcement actions. The Enforcement Section has a staff of eleven authorized positions whose responsibilities include (1) participating in decisions regarding the initiation of formal enforcement actions; (2) preparing draft and final orders, agreements, and notices and memoranda relating to such actions; and (3) negotiating the provisions of formal enforcement actions with boards of directors of problematic financial institutions and related individuals.³ BS&R's Enforcement Section, in conjunction with the Special Investigations and Examinations Section, is also responsible for all Board matters related to criminal activities at financial institutions subject to the Board's jurisdiction, including the review of Suspicious Activity Reports (SARs), which are explained

³Nine positions are currently filled.

in more detail on page 7. As shown in figure 2 (next page), other Board divisions and other sections within BS&R provide support to BS&R's Enforcement Section, depending on the type of institution involved and the specific reason for the corrective supervisory action.

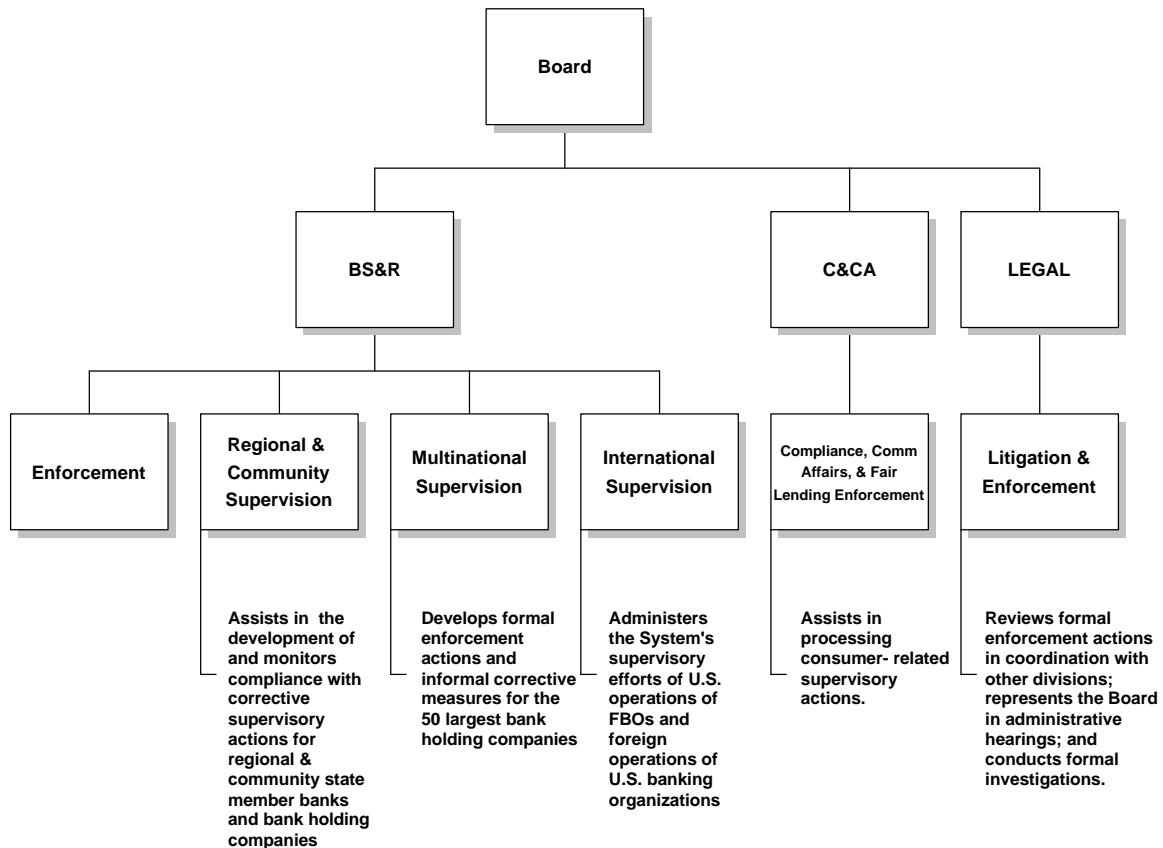
Processing Procedures

The need for a corrective supervisory action is usually identified during a state member bank or FBO examination or bank holding company inspection, although it may also be otherwise identified such as through the System's off-site surveillance process. The determination as to whether the action should be formal or informal is generally made by the Reserve Bank with input from Board staff, as required, and is based on several criteria, including the institution's composite rating and financial condition, the type and severity of deficiencies discovered, and the capabilities and cooperativeness of the institution's management.

If an informal supervisory action is warranted, the Reserve Bank develops and approves the action according to its internal processing procedures; MOUs with FBOs, although considered informal actions, must be coordinated with BS&R's International Supervision Section. If a formal enforcement action is required, the Reserve Bank must send a copy of the draft action to BS&R's Enforcement Section for processing and Board approval. If an institution's management consents to an action, the Board has delegated the authority to enter into a formal enforcement action to the General Counsel with the concurrence of the Director of BS&R, although Reserve Banks may enter into written agreements with the prior approval of both the Director of BS&R and the General Counsel. Board staff may also present cases to the Committee on Supervisory and Regulatory Affairs or the Board for review and approval depending on the issues involved. If the institution's management does not consent to the action, the action must be litigated in accordance with the provisions of the Administrative Procedures Act, and the planned litigation is presented to the Board for review and approval. Reserve Banks are responsible for monitoring compliance with the provisions of all enforcement actions.

In addition to the general processing procedures discussed above, the System implemented the Fast Track Criminal Referral Enforcement Program in April 1995. The program uses expedited enforcement procedures to obtain consent orders of prohibition from banking officials and employees under certain circumstances. The program covers cases involving reported losses

Figure 2
Board Entities Involved in Enforcement Activities



greater than \$25,000 but less than \$100,000 which law enforcement agencies have declined to prosecute and in which the individuals involved have signed a confession or otherwise admitted guilt. The program may also seek restitution from the individuals through cease-and-desist orders.

Automation

Federal Reserve staff use a variety of information systems to track and monitor corrective supervisory actions. For example, BS&R's Enforcement Section uses the Enforcement Action Tracking System (EATS) to track formal enforcement actions. EATS is a custom-built database application that helps the Enforcement Section monitor the progress of actions through the Board's review process from the time the actions are received from the Reserve Banks to the time they are sent back to the Reserve Banks for execution. Access to EATS is limited to the Enforcement Section's administrative staff. EATS was designed to replace Cornerstone, the Enforcement Section's original enforcement action tracking system. Because data conversion has not been completed, Enforcement Section staff maintain Cornerstone in parallel with EATS.

Other supervisory sections in BS&R and the Reserve Banks use the Supervisory Information System (SIS) to support their bank supervisory responsibilities, including the processing of corrective supervisory actions. SIS is a database within the National Information Center (NIC) that maintains supervisory, financial, regulatory, and administrative information gathered during examinations and inspections; a section of SIS is dedicated to maintaining enforcement information provided by the Reserve Banks.⁴ The Federal Reserve Examination Database (FRED) is a local database used by the Reserve Banks to maintain certain supervisory information downloaded daily from SIS. Because SIS queries can be difficult to formulate, FRED was designed to allow nontechnical users, especially managers, to access key supervisory data using point-and-click technology in a Windows environment. Reserve Bank and Board staff use SIS/FRED in a variety of ways, including querying enforcement information and generating management information reports. The National Examination Database (NED) is the designated replacement for SIS and FRED. In addition to maintaining much of the enforcement data now maintained by SIS, NED will provide additional data fields and allow greater design flexibility. NED is scheduled to go into production in early 1998.

In addition to the systems discussed above, each Reserve Bank has its own enforcement tracking and monitoring systems. These systems range from simple spreadsheets and word processing documents to sophisticated database applications designed in-house. Some of these systems are maintained independently of SIS/FRED; others rely on downloaded SIS/FRED data. In general, the Reserve Banks use these systems to track actions in process, monitor compliance after actions have been issued, and generate management information reports.

Suspicious Activity Reports

Since the mid-1980s, banks have been required to file reports alerting regulators and law enforcement personnel of possible criminal or suspicious activity affecting or conducted through their institutions. Banks reported these activities by filing multiple copies of Criminal Referral Forms with their respective federal regulators and law enforcement agencies. The Federal Reserve, along with the other federal banking agencies and the U.S. Department of the Treasury's Financial Crimes Enforcement Network (FinCEN), established new suspicious activity reporting rules and, on April 1, 1996, implemented a new suspicious activity reporting program. Banks must now file a new Suspicious Activity Report (SAR), which replaces the System's Criminal Referral Form, with FinCEN, rather than with several federal departments and agencies. A new FinCEN SAR database is accessible by each of the federal banking agencies and numerous federal and state bank regulatory and law enforcement authorities. Supervisory personnel review SAR data to identify matters of potential concern such as large losses or internal control weaknesses at regulated institutions, to investigate inappropriate or unlawful activities, and to initiate appropriate enforcement actions.

OBJECTIVES, SCOPE, AND METHODOLOGY

⁴The NIC is a central repository containing information about all U.S. banking organizations and their domestic and foreign affiliates. It also contains information on foreign banking organizations located in the U.S. The NIC is a comprehensive research and supervisory system for the monitoring and analysis of banking organizations and the banking industry as a whole.

We conducted our fieldwork from February through June 1997. Our overall objective was to evaluate the economy and efficiency of the System's enforcement activities. Specifically, we wanted to determine whether

- corrective supervisory actions could be processed more efficiently;
- appropriate levels of resources are used to develop, process, track, and monitor corrective supervisory actions;
- any duplication of effort exists between the Board and Reserve Banks; and
- opportunities exist to streamline the process or to reduce regulatory burden.

To accomplish these objectives, we reviewed the processing of corrective supervisory actions from the time that the need for an action was identified through the time that the action was taken or litigated and until the time that the action was terminated. We reviewed corrective supervisory actions processed during 1995 and 1996 for foreign and domestic institutions and selected a judgmental sample of sixty corrective supervisory actions initiated by six Reserve Banks. For each of the actions selected, we reviewed Board and Reserve Bank files and discussed processing procedures with System staff. We also reviewed Board and Reserve Bank policies, procedures, and related documentation. As part of our review of SAR processing, we interviewed responsible System staff and judgmentally sampled several SARs to document processing and follow-up procedures. We also met with officials from the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision to discuss general processing procedures for corrective supervisory actions in those agencies.

In addition, we reviewed the resources required for developing, processing, tracking, and monitoring supervisory actions, including automation resources and Board staffing and structure. We interviewed individuals responsible for automated systems at the Board and Reserve Banks to identify the information contained in each of the systems. We also obtained reports from the various systems to assess the degree to which corrective supervisory actions are tracked. Although we performed limited testing of the validity and reliability of the information contained in the various automation systems, our tests identified data discrepancies as discussed in recommendation 1 (page 10). We did not assess the computer-based systems' internal controls because this was not a primary objective of the audit. Our audit was performed in accordance with generally accepted government auditing standards.

FINDINGS, CONCLUSIONS, AND RECOMMENDATIONS

Overall, we found that the System's processing of corrective supervisory actions was generally efficient, although the time it takes the System to process an action and the level of involvement by Board and Reserve Bank staff vary widely, depending on the type of action being processed, the type of entity subject to the action, the nature of the underlying supervisory problem, and the willingness of the entity to consent to the action. Our review of sixty corrective supervisory actions did not identify any systemic processing weaknesses or inefficiencies. We also found that cooperation between the Board and Reserve Bank staffs, and between various sections at the Board, was generally effective and that the System can expedite processing if required to meet special circumstances.

Notwithstanding its general efficiency in processing individual actions, we found that the System lacks a management information system that provides accurate and comprehensive enforcement data and consistent reporting Systemwide. The Board and Reserve Banks maintain a variety of independent information systems for tracking, monitoring, and reporting enforcement actions which we believe the Director of BS&R should eliminate in favor of a Systemwide management information system that would efficiently provide accurate enforcement information to all organizations involved in enforcement.

We also found that additional opportunities exist to further improve processing efficiency, minimize duplication of effort, and strengthen the controls over the enforcement function and associated resources Systemwide. Specifically, we believe the Board should increase the Reserve Bank's authority to process certain corrective supervisory actions to streamline the process and reallocate staffing levels accordingly. We also believe the Director of BS&R should update enforcement policy and guidance to make them more consistent and complete and define more clearly the objectives of SAR processing.

The current enforcement process requires the participation of the Reserve Banks, BS&R's Enforcement Section, three other BS&R supervisory sections, C&CA, and the Legal Division's Litigation and Enforcement Section; none of the entities involved has complete responsibility for the entire enforcement function. Our audit showed that lack of a central unit with responsibility for coordinating the System's enforcement activities contributed to several of the problems we identified. We are not making any structural recommendations at this time. The Director of BS&R is already taking action to reorganize the division. The reorganization, coupled with recent Boardwide budget initiatives, provides a good opportunity for the Board to address enforcement roles and responsibilities and to ensure that the division's new structure encompasses all aspects of the enforcement function, including determining resource requirements, establishing program guidance, and providing program oversight.

1. We recommend that the Director of BS&R eliminate redundant tracking systems to promote data accuracy, reporting efficiency, and data consistency.

The System tracks and monitors corrective supervisory actions using a variety of independent information systems, including SIS/FRED, EATS, Cornerstone, internally-developed Reserve Bank systems, and an enforcement action database used to support the Board's public website.⁵ As a result, participants in the enforcement process rely on various sources of enforcement information. For example, the Reserve Banks and certain BS&R supervisory sections use SIS/FRED to query enforcement data; however, BS&R's Enforcement Section does not rely on SIS/FRED for its enforcement information needs. The Reserve Banks and BS&R supervisory sections cannot, however, access EATS and Cornerstone, which are the Enforcement Section's primary tracking systems. In addition, the internal tracking systems developed by each of the Reserve Banks are not available to the other Reserve Banks or the Board and are often used in parallel with SIS/FRED. As discussed below, our review of these systems identified instances of data inaccuracies, reporting inefficiencies, and inconsistent data input which we believe are caused by the use of multiple, independent information systems.

To evaluate the level of data accuracy among the various information systems, we compared 1995 and 1996 completed enforcement action data maintained by SIS and EATS. We first tested whether the records in SIS and EATS matched. Our test showed that 34 out of 124 records (27 percent) tested in SIS were not in EATS and 51 out of 141 records (36 percent) tested in EATS were not in SIS. For the 90 records that did match, we compared similar data fields—such as type of action, institution name, and date of action—to determine if they agreed between the two systems. We

⁵The Board's public website uses a separately-maintained database application to support an enforcement web page. The Board's Division of Information Resources Management maintains the website and manually updates the associated database using information generated from the Cornerstone system.

used by staff throughout BS&R for a variety of purposes. We observed that the supervisory action section of the annual questionnaire is not compiled by BS&R's Enforcement Section but rather by other staff in BS&R. These statistics are manually provided by the Reserve Banks that use SIS/FRED and/or their own internally developed systems to generate the enforcement information. BS&R's Enforcement Section does not use any of the supervisory action data produced by the annual questionnaire. We believe the current procedures for collecting enforcement information from multiple sources increase the risk of reporting errors and represent an ineffective use of automation resources.

Finally, we noted inconsistencies and confusion regarding the input of data in information systems. For example, according to the manual, *Operating Assistance for the Supervisory Information System*, the "Date Action Started" is the day on which the Reserve Bank determines that a supervisory action is necessary for an entity. We found that each of the Reserve Banks we visited defines this date differently. For example, one Reserve Bank defines this date as the date an action is discussed at the postexamination briefing, while another Reserve Bank defines it as the date a management Committee decides to go forward with an action. As a result, the "Date Action Started" data fields in SIS are populated with inconsistent information, which could hamper data analysis and reporting. We also noted there is confusion among the Reserve Banks as to how to record enforcement actions that are input by multiple Reserve Banks in the SIS database. This confusion has caused instances in which SIS records have been duplicated or miscoded. During our review of EATS, we observed that many of the fields used to record significant dates in the Board's enforcement action review process were empty. As a result, EATS's value as a tracking tool is diminished.

As described on page 7, NED is the designated replacement for SIS and FRED. We believe that the development of NED provides an opportunity to establish a primary tracking and monitoring system for all enforcement information. In addition to having the same Systemwide connectivity as SIS/FRED, NED will improve tracking capabilities, allow greater design flexibility, and provide a more user-friendly interface. As the primary enforcement information system, NED will also enhance the Federal Reserve System's ability to analyze and report enforcement information. Although NED should reflect the requirements of all users and be implemented with the intent of eliminating duplicate systems, we recognize the Reserve Banks, the Enforcement Section, and other involved BS&R sections may have certain additional tracking needs. These organizations can download NED data into local tracking support applications if necessary, but to avoid data accuracy problems, these customized applications should be driven by NED data that are updated regularly.

2. We recommend that the Board increase the Reserve Banks' authority to process certain corrective supervisory actions and reallocate staffing levels for entities involved in enforcement activities accordingly.

Reserve Banks now process most informal supervisory actions without Board or Board staff involvement. However, Supervisory Letter SR 92-24, "Informal Enforcement Actions Involving Foreign Banking Organizations," requires the Reserve Banks to submit all informal, as well as formal, supervisory actions against FBOs to the staff of BS&R's Enforcement and International Supervision sections for review prior to presentation. According to staff, this policy has been

modified for informal actions and only MOUs are submitted. The Board or Board staff approves all formal enforcement actions, although follow-up and monitoring are Reserve Bank responsibilities.

Most Reserve Bank staff we talked to said that increased delegated authority would improve processing efficiency. We found that the Reserve Banks already complete much of the processing for corrective supervisory actions—identifying problems, interacting with the institution, and drafting the actions. We believe allowing the Reserve Banks to process a wider range of actions would place a greater portion of the workload at a level that has more flexibility to shift resources in response to changes in the overall volume and nature of supervisory actions. This change would also allow Board staff to focus on the most important cases.

One corrective supervisory action that we believe could be devolved to the Reserve Banks now would be to allow them to process MOUs for FBOs if the action is the result of an examination or inspection and involves only a single entity. MOUs resulting from home country concerns could still be processed using current procedures until the System has greater experience with the new Foreign Bank Supervision and Enforcement Act of 1991 (FBSEA) responsibilities. This change would require updating SR 92-24.

In addition, we believe the Board should specifically review whether its rules on delegation for organizations could be revised to allow Reserve Banks to enter into all formal enforcement actions subject to the prior approval of the Director of BS&R and the Board's General Counsel. This change would simplify existing delegation rules and establish consistency in the processing of formal enforcement actions. We also believe the Board should consider allowing Reserve Banks, on a case-by-case basis, to approve certain formal actions (such as modifications and terminations to existing written agreements) without Board or Board staff prior approval.

Once the decisions have been reached regarding the Reserve Banks' processing authority, the Board should evaluate and appropriately adjust the current staffing levels related to enforcement activities to ensure that appropriate staff resources are supporting the enforcement mission. The Board should also consider reallocating staffing levels based on the declining volume of enforcement actions. We found that the volume of formal enforcement actions declined from 295 actions in 1992 to 53 actions in 1996. However, we noted that the authorized Enforcement Section staffing level, for example, was the same in 1996 as in 1992. Although we recognize that staffing requirements are based on factors other than the number of actions processed (e.g., the complexity of the underlying supervisory problem), we believe the current BS&R reorganization and the ongoing Boardwide budget initiatives give the Board an opportunity to ensure that staffing levels are reasonable and properly allocated.

3. We recommend that the Director of BS&R update, consolidate, and complete enforcement policies, guidance, and procedures.

Enforcement policy and guidance can be found in various sources. Supervision and regulation letters, administrative letters, and the *Commercial Bank Examination Manual (CBEM)* discuss aspects of the enforcement process. The Enforcement Section has also developed a manual containing procedures for Enforcement Section staff and examples of draft corrective supervisory actions (the *Procedures Manual*). In addition, each of the six Reserve Banks we visited has developed an internal policy and procedures manual. These sources, however, address only portions of the overall enforcement process.

We found that policy and guidance is not complete, consistent, or up to date. For example, we found only limited guidance concerning informal supervisory actions although these actions represent the majority of actions taken by the System. The result is inconsistencies in the way different organizations within the System categorize informal actions. We also found that, although the Enforcement Section's internal manual contains procedures for Enforcement Section staff, it does not discuss responsibilities for staff in other Board divisions or the Reserve Banks. In addition, although the Reserve Banks used the examples in the *Procedures Manual* as a guide for drafting enforcement actions, Enforcement Section staff told us that the manual had not been updated for more than two years. In our opinion, updating the examples would reduce editorial time spent by Board staff.

In addition to updating and consolidating current policy and guidance, we found areas where policy and guidance were lacking. Areas we believe require additional guidance are described below.

- Automation: Guidance should cover expectations and requirements for use of the new management information system (NED), standard terminology, and common data elements.
- SAR reviews: Guidance should cover expectations of the program and use of the FinCEN data.
- Processing timeframes: BS&R could establish timeframes to enhance efficiency, particularly if Reserve Banks are given additional processing authority. We observed that Reserve Bank internal processing manuals generally included benchmark timeframes which we believe could be incorporated with Board timeframes in Systemwide guidance to provide general standards for evaluating performance and identifying bottlenecks.

We believe that updating and consolidating policy and guidance will help generate consistency and completeness and ensure that all aspects of the Board's enforcement program are covered. One way to accomplish this would be to use the current *Procedures Manual* as a baseline and expand its focus to include other entities in the System with enforcement responsibilities. Although each Reserve Bank would still maintain an internal procedures manual to document District-unique procedures, a central policy and procedures manual could incorporate best practices or lessons learned from across the System. Another option would be to expand the *CBEM's* section on formal corrective actions to encompass a broader range of enforcement information.

4. We recommend that the Director of BS&R update program objectives relating to SAR data, revise staff responsibilities to eliminate duplication of effort, and issue guidance to the Reserve Banks on the use of SAR information.

The implementation of the new SAR program represents a significant change in the way suspicious activity is reported by financial institutions and accessed by regulators. Despite the effects of these changes, we found that BS&R's Enforcement Section has not updated its program objectives to reflect the SAR program changes. We believe that the opportunities represented by the new database system to retrieve, sort, and analyze data should be clearly defined for BS&R's Enforcement Section, especially because SAR review represents one of only three overall objectives for the section. In addition, we believe that the Director of BS&R should review the SAR program and establish objectives for the Reserve Banks regarding access, retrieval, and follow-up of SAR information.

In addition to updating program objectives, we believe the director should review SAR processing procedures because Board staff's SAR database review and referral activities unnecessarily duplicate Reserve Bank efforts. We observed that Board staff routinely scan the SAR database to identify certain SARs that warrant some form of follow-up. These SARs include those which meet the criteria for the fast track program and those otherwise judged to be significant for their potential effect on the safety and soundness of the financial institution. Board staff sends these SARs to the appropriate Reserve Bank for follow-up. But Reserve Bank staff also have direct access to the SAR database, and all of the Banks we visited had developed procedures to identify SARs that meet the same criteria used by Board staff. We believe Board interests would be better served by monitoring Reserve Bank SAR review activities and pending SAR investigations.

We also found that the Board has not issued formal guidance to the Reserve Banks on the use of the SAR data beyond providing training materials focusing on how to access the SAR database. We believe that SAR data provides Reserve Banks with a valuable tool to assist in planning risk-focused examinations since the SAR database contains information that can aid bank supervisors in assessing the adequacy of bank internal controls and overall bank safety and soundness. The information also provides data specific to individual enforcement and investigative efforts. However, lack of Board guidance on the program's overall objectives, the minimum review and follow-up criteria, and when or whether to refer a particular SAR to examination staff have resulted in duplication of effort in review activities and may result in some Reserve Banks devoting time and resources to SAR reviews beyond the program's expected benefit.

Each of the six Reserve Banks we visited had developed different procedures for SAR review and follow-up. Staff members at some Reserve Banks accessed the database as often as daily to identify SARs filed by regulated institutions, but staff at other locations accessed the database weekly, every other week, and monthly to discover newly-filed SARs. At some Reserve Banks, staff members refer every SAR filed to examination staff for their review, while at other Reserve Banks review criteria have been established—such as a minimum dollar amount or whether a reported suspect is a bank insider (i.e., a bank employee, officer or director)—to identify SARs which require follow-up and referral to safety and soundness staff. One Reserve Bank simply relies on the judgment of the staff member scanning the database to determine if SAR follow-up and referral to examination staff are needed. We also observed that the Reserve Banks do not always document the results of follow-up activities and analysis of the significance of a particular SAR filing, although when the Reserve Banks were considering possible enforcement actions—for example, in potential fast track enforcement

cases—the Banks maintained documentation on file. We believe that adequately documenting all follow-up activities is important to provide evidence of review and analysis of the significance of a particular SAR filing.

In our opinion, the requirements provided to FinCEN by the federal financial institution regulators for identification of “priority” SARs establish a reasonable minimum review requirement. These requirements include all SARs filed in which the suspect is a bank employee, officer, or director; in which the amount is greater than \$200,000; or in which the suspicious activity reportedly had a material impact on the institution’s safety and soundness. We believe the Director of BS&R should review these criteria and develop System SAR review guidelines for the Reserve Banks. During our audit, Board staff developed draft SAR review guidelines for inclusion in the *Bank Secrecy Manual*. We believe the draft represents a starting point toward providing the Reserve Banks with expectations on use of SAR data.

APPENDIXES

Appendix 1 - Definitions of Corrective Supervisory Actions

The *Operating Assistance for the Supervisory Information System* manual contains the following definitions of corrective supervisory actions:

Informal Supervisory Actions

Board Resolution. A unilateral (single party) resolution adopted by the institution's board of directors at the request of a regulatory agency.

Commitment Letter. A request by the regulatory agency that the institution's management or board of directors sign a letter undertaking certain commitments to correct deficiencies in the institution.

Memorandum of Understanding. A bilateral (two party) agreement between a Federal and/or State regulatory agency and an institution.

Other Informal Action. Other informal actions initiated by the Federal Reserve System, State agencies, or other regulatory agencies to correct supervisory issues.

Formal Enforcement Actions

Capital Directive. A unilateral order for an institution to increase its capital to a given level.

Cease and Desist Order. An action issued by the Board of Governors either by consent or upon the issuance of a Notice of Charges under Section 8(b) of the Federal Deposit Insurance Act (FDI Act).

Civil Money Penalties. Monetary assessments for violations of law or regulation, failure to comply with formal enforcement actions, or engaging in unsafe and unsound practices or breach of fiduciary duty.

Order of Investigation. Investigation authorized by the Board of Governors pursuant to 12 USC 1818(n) and 1820(c) and 12 CFR(b)(12) designating representatives of the Board of Governors to gather evidence and information, to administer oaths and affirmations, to take or cause to be taken depositions, and to issue, revoke, or modify subpoenas.

Other Formal Action. Other formal action enforceable in a court of law.

Prompt Corrective Action. Action initiated under Section 38 of the FDI Act to increase an institution's capital and implement legislated operating restrictions on the institution.

Appendix 1 - Definitions of Corrective Supervisory Actions (continued)

Prohibition Order. Action initiated under Section 8(e) of the FDI Act to prohibit the institution-affiliated party from participating in the business of banking.

Temporary Cease and Desist Order. Unilateral action issued under the authority of Section 8(c) of the FDI Act.

Temporary Suspension Order. Action initiated under Section 8(e)(3) of the FDI Act to temporarily suspend an institution-affiliated party from participating in the affairs of a depository institution.

Written Agreement. Formal action issued by the Federal Reserve System and enforceable under section 8(b) of the FDI Act.

Appendix 2 - Legal Division's Comments

September 5, 1997

TO: Office of Inspector General SUBJECT: Draft Report on the
Federal Reserve System's
Enforcement Activities (A9613)

FROM: Legal Division
(Messrs. Mattingly &
Ashton)

This is in response to your request for comments on the draft *Report on the Federal Reserve System's Enforcement Activities* (A9613).

The bulk of the findings and recommendations in the draft report do not directly affect the Legal Division, so we are not in a position to comment on these matters. We have limited comments on two issues concerning the second recommendation in the draft report, which addresses increased delegation of authority to the Federal Reserve Banks to process certain supervisory actions.

One of the recommendations on delegation is that, for simplification and consistency purposes, the Board should specifically review whether its rules on delegation of authority for supervisory actions against domestic organizations should be revised to allow Reserve Banks to enter into all formal actions, subject to the approval of Board staff. Currently, the delegation rules authorize the Reserve Banks, with the approval of Board staff, to enter into consent written agreements, and authorize Board staff to approve, on behalf of the Board, consent cease and desist orders.

The fact that the Board signs a cease and desist order and the Reserve Bank signs a written agreement is the only real distinction between the two kinds of actions. Both actions

Appendix 2 - Legal Division's Comments (continued)

have the same binding effect on the individual or institution and are equally enforceable. Although, as the draft report correctly notes, whether the Board or the Reserve Bank signs the action appears to be just a formality, our experience shows that in practice this distinction can serve a useful purpose.

This is because the issuance of a cease and desist order by the Board against an institution or individual, as opposed to a written agreement entered into by a Reserve Bank, is understood by the industry to represent a more serious sanction, even though the actual provisions of the cease and desist order may be no more stringent than what is ordinarily found in the typical written agreement. The existence of this perception gives the Board an additional enforcement tool. If we want to signal to the institution or to the industry generally that certain misconduct is viewed more seriously by the Board, we can require the institution or individual consent to an order directly with the Board, as opposed to an action where the Reserve Bank is the party.

Allowing the Reserve Banks to be the signatories of cease and desist orders as well as written agreements would all but eliminate the distinction between the two actions. Thus, although we cannot dispute that the change in the delegation rules recommended in the draft report would facilitate uniformity and simplification, maintaining the current delegation provisions on cease and desist orders would help to preserve an additional enforcement tool and to afford greater flexibility to dealing with problem situations.

Another recommendation in the draft report is that the Board should consider amending the delegation rules to allow the Reserve Banks, on a case by case basis, to approve certain formal actions, such as modifications and terminations of existing written agreements, without

Appendix 2 - Legal Division's Comments (continued)

Appendix 2 - Legal Division's Comments (continued)

approval of Board staff or the Board. The report does not recommend that existing delegation rules be changed so that Reserve Banks would be authorized to approve issuance of new written agreements.

We agree that this recommendation could be implemented for some types of formal actions. Many, if not most, written agreements primarily address safety and soundness problems, such as inadequate capital or lack of controls, and not violations of law or regulations. With regard to termination of existing written agreements, our current practice in reviewing Reserve Bank recommendations is, where the written agreement is limited to safety and soundness issues, to defer almost completely to the views of the particular Reserve Bank on the advisability of continuing the action. Thus, allowing the Reserve Bank to terminate these kinds of agreements without obtaining approval at the Board level would save some Board resources and would not change the outcome recommended by the Reserve Bank.

With regard to modifications of existing written agreements, if new substantive provisions are going to be added to an existing agreement, the modification would be equivalent to issuing a new agreement, at least to the extent of the new provisions, so that there should be Board approval. On the other hand, if the modification is to eliminate part, but not all, of the provisions of an existing written agreement that concern safety and soundness issues, then the existing Board approval requirement could be eliminated for the reasons stated above.

Appendix 3 - Division of Banking Supervision & Regulation's Comments

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

MEMO

DATE: October 8, 1997
TO: Barry R. Snyder
FROM: Mr. Spillenkothen
SUBJECT: Draft Report on the Federal Reserve System's Enforcement Activities

Thank you for the opportunity to review the draft Report on the Federal Reserve System's Enforcement Activities. Below, we provide some general comments on the draft report's findings and recommendations, then provide some background information concerning the Federal Reserve's enforcement activities that is essential to an analysis of the draft report, and, finally, respond to the report's four recommendations.

General Comments

As described in the draft report, the purpose of the Inspector General's audit was to evaluate the economy and efficiency of the System's enforcement activities. Given the highly judgmental nature of enforcement activities, the Inspector General staff's focus on the processing of enforcement actions and steps that can be taken to improve efficiencies in this area, rather than on whether the proper action was taken, was appropriate.

With regard to the processing of enforcement actions, we are pleased to learn that your review showed that the System's processing of individual enforcement actions was generally efficient, that the cooperation between Board and Federal Reserve

Bank staffs was generally effective, and that the System can expedite processing when required to meet special circumstances. These findings are based on an extensive review of 60 enforcement actions taken over a two-year period, involving six Federal Reserve Banks.¹ We are equally gratified that the Inspector General staff's review of the 60 actions did not identify any systemic processing weaknesses or inefficiencies, and, in particular, did not report any instance where applicable laws were not complied with fully or required procedures were not followed.

In addition to the favorable findings about the processing of enforcement actions taken by the Federal Reserve, which are the results of the efforts of the Division of Banking Supervision and Regulation, the Legal Division, and the Federal Reserve Banks (and at times the Division of Consumer and Community Affairs), the staff of the Inspector General noted some areas where efficiencies can be improved. These related to databases, manuals, and suspicious activity reporting. While it is important to recognize that the draft report did not identify any negative effects on any of the 60 enforcement actions it reviewed resulting from the cited problems, we understand that some improvements to the enforcement process can be made. To this end, we have considered the recommendations in the draft report and have implemented or are in the process of implementing most of them as described in the part of this memorandum entitled "Responses to Recommendations". First, however, we describe below some important background information regarding the Federal Reserve's enforcement activities.

Background

As you and the members of the Inspector General's review team are aware, the Federal Reserve undertakes various types of enforcement actions to address problem situations that range from minor safety and soundness matters and single law or regulation violations to extremely serious instances of pervasive noncompliance with basic safe and sound operating standards and the corruption of the bank examination process. Enforcement actions are supervisory tools used by the staffs of the Federal Reserve Banks and Board and can be informal in nature and not legally binding (such as memorandums of understanding and board resolutions executed or adopted by or at the request of Federal Reserve Banks), or formal and legally enforceable. Generally,

¹The cases ranged from the termination of a foreign banking organization's activities in the United States and some significant civil money penalty assessment actions to routine informal enforcement actions involving memorandums of understanding against small banking organizations.

informal enforcement actions are handled entirely by the staffs of the Federal Reserve Banks, with Board staff providing input only when requested. Formal enforcement actions, such as cease and desist orders, civil money penalty assessment orders, and prohibition orders, are processed jointly by the staffs of the Board's Division of Banking Supervision and Regulation's Enforcement Section and Legal Division, based most often on recommendations submitted by the Federal Reserve Banks. Generally, formal actions are undertaken for various purposes ranging from ensuring that appropriate corrective actions are taken by banking organizations to penalizing wrongdoers or permanently barring individuals from the U.S. banking industry.

Problem situations differ, and the staffs of the Federal Reserve Banks and the Board use their judgment, sometimes augmented by guidance provided by the Board or an oversight Committee, to determine when to use the various supervisory tools available to them. When decisions are made to undertake an enforcement action, the staffs of the Federal Reserve Banks and the Board follow various, and sometimes different, procedures to process the action depending on whether the action is informal or formal, and the purpose of the enforcement action (e.g., corrective or punitive). Depending on the type of enforcement activity, the procedures are purposefully simple, such as when informal enforcement actions are contemplated to ensure, for example, the prompt adoption of a necessary board resolution while a bank examination is in progress. They are more complex and formal, especially where a legally binding--and potentially contested--formal enforcement action (such as an order barring an individual from the banking industry or fining a major financial institution) is being proposed. The procedures are at times mandated by federal law, are often required by regulations issued by the Board, and are always undertaken in conformance with interagency policies adopted as the result of actions by the Federal Financial Institutions Examination Council, and with longstanding internal Federal Reserve processing guidelines.

In 1966, the Board and the other federal banking agencies were authorized to use formal enforcement actions to address, inter alia, violations of law, unsafe or unsound practices and breaches of fiduciary duty. Since 1966, the Board issued or executed, directly or through delegated authority, approximately 1,500 orders and written agreements; over the same period, the Federal Reserve Banks completed more than 1,800 informal enforcement actions. Over the past 30 years, very few Federal Reserve enforcement-related matters had to be contested in administrative hearings (11 hearings), and few orders were challenged in federal court (10 federal district court or U.S. court of appeals cases). The Federal Reserve has basically

Appendix 3 - Division of Banking Supervision & Regulation's Comments (continued)

prevailed in every administrative hearing, and, with one exception in 1986, has had its orders upheld in every federal court challenge to a Federal Reserve enforcement action involving a banking organization within the agency's jurisdiction. By any standard, for 30 years, the Federal Reserve has been successful in putting into place appropriate enforcement actions, in timely fashion, through the cooperative efforts of the staffs of the Federal Reserve Banks and the Board, and often with the assistance and collaboration of representatives of state bank regulatory authorities.

Responses to Recommendations

Recommendation 1: We recommend that the Director of BS&R [Division of Banking Supervision and Regulation] eliminate redundant tracking systems to promote data accuracy, reporting efficiency, and data consistency.

The staff of the Inspector General conducted a review of the Federal Reserve databases that contain information concerning enforcement actions, and found some inconsistencies related to bank examination and enforcement-related information. In essence, Inspector General staff found the following three problems associated with automated databases, and data collection and reporting: (1) the inconsistent tabulation of the number of completed informal enforcement actions; (2) the lack of integration between the database maintained by the Enforcement Section and SIS/FRED; and (3) inconsistencies with regard to some non-essential bank supervision-related information in SIS/FRED.

We agree that there have been discrepancies in data relating to some aspects of enforcement activities, and each of the foregoing three matters will be rectified as described below.

Turning to the first of the three noted deficiencies concerning the annual count of the number of completed informal enforcement actions, Inspector General staff found that the Federal Reserve Banks maintain information about their completed informal enforcement actions in SIS/FRED (and in the near future in NED), and that the staff of the Enforcement Section surveys each of the Federal Reserve Banks once a year to determine the number of completed informal enforcement actions in order to complete a part of the Board's annual report to Congress, rather than relying on SIS/FRED data. In the past, the numbers of completed informal enforcement actions generated by SIS/FRED were different than the survey results. There should, of course, be one consistent mechanism to count and report the number of completed informal enforcement actions. As the staff of the Division of Banking Supervision and Regulation advised Inspector General staff during the course of its program review, starting

with the Board's annual report submitted to Congress in 1998 covering enforcement activities in 1997, the staff of the

Division's Enforcement Section will henceforth rely on SIS/FRED (and subsequently NED) data relating to the number of completed informal enforcement actions taken by the Federal Reserve Banks for year-end annual report purposes.

The second deficiency relates to the lack of integration between the Enforcement Section's database, which maintains information relating to the formal enforcement actions undertaken by the Federal Reserve, and SIS/FRED, which maintains bank supervision-related information regarding all of the various banking organizations supervised by the Board and includes as an ancillary matter information regarding informal and formal enforcement actions. Because of this lack of integration of data between the two systems, Inspector General staff found that some categories of information may not be consistent. While the specific data categories are not identified in the draft report, we can nonetheless agree that, to the extent that automation processes permit the electronic integration of information concerning formal enforcement actions, our staffs should explore with Board and Federal Reserve Bank staff responsible for the development and implementation of NED, including staff from the Division's new Supervisory Information Technology Section, the integration of the two automated databases.

The third problem identified by the staff of the Inspector General concerns certain data inconsistencies relating to bank supervision-related information within SIS/FRED. After reviewing the draft report's findings, we agree that there appears to be some inconsistencies; they are minor and can be corrected.

Recommendation 2: We recommend that the Board increase the Reserve Bank's authority to process certain corrective supervisory actions and reallocate staffing levels for entities involved in enforcement activities accordingly.

This is the most critical of the many areas of the Federal Reserve's enforcement activities reviewed by Inspector General staff.

Inspector General staff correctly describes the general nature of the roles of the staffs of the Board and the Federal Reserve Banks in the enforcement action process. The Federal Reserve Banks are practically solely responsible for determining whether an informal enforcement action such as a memorandum of understanding is needed and then developing the parameters of the action and getting it put into place through meetings and

Appendix 3 - Division of Banking Supervision & Regulation's Comments (continued)

discussions with the management and directors of banking organizations they oversee. Because informal enforcement actions

are not legally binding and pose little or no risk to the Federal Reserve, Board staff plays almost no role with respect to the initiation, completion, or monitoring of any informal actions, with one exception relating to foreign banking organizations. The policies and procedures relating to the processing of informal enforcement actions are established by each of the Federal Reserve Banks and, with the exception of mandatory interagency notification procedures, Board staff has traditionally not overseen the Federal Reserve Banks' activities in this area.

With regard to formal enforcement actions such as cease and desist orders and prohibition orders, Enforcement Section and Legal Division staffs always work together along with the staffs of the Federal Reserve Banks. Often, Board staff works with representatives of the Board's Division of Consumer and Community Affairs in the event that a formal enforcement action involving violations of consumer protection statutes and regulations is proposed, and with state bank supervisory authorities if the action involves a state chartered banking organization, such as a state member bank or branch or agency of a foreign bank. Formal enforcement actions are legally binding and may be contested in administrative proceedings or federal court. They are also made public by law and, thus, subject to scrutiny by the banking industry, media, Congress, General Accounting Office, and public. For these reasons, policies and procedures relating to the processing of formal enforcement actions have been established by Board staff, and Board staff is intimately involved with the processing and oversight of such actions.

In its draft report, Inspector General staff makes several recommendations regarding how the Federal Reserve Banks' roles can be expanded with regard to informal and formal enforcement actions. We have considered the recommendations and will implement some aspects of them, as described below.

First, Inspector General staff points out that, unlike informal enforcement actions involving domestic banking organizations, the Federal Reserve Banks are not authorized to finalize informal enforcement actions relating to foreign banking organizations without the prior review and approval of the staff of the Division of Banking Supervision and Regulation pursuant to a policy established by the Division in SR 92-24. Basically, this policy decision by the International Supervision staff of the Division was made at the inception of the foreign bank supervision program (FBO Program) in order to ensure that supervisory actions against foreign banking organizations operating in the United States are consistent throughout the Federal Reserve System and properly coordinated with state bank regulatory authorities. A policy decision was made by the Director of the Division of Banking Supervision and Regulation to require all follow-up supervisory actions involving foreign banking entities subject to the FBO Program to be overseen by senior Division staff prior to

their presentation to any U.S. branch or agency, or overseas banking organization operating a U.S. office.

As the staffs of the Board and the Federal Reserve Banks gain additional experience with supervising foreign banking organizations under the FBO Program, it is expected that changes will be made to the program. It is possible that one change will be to delegate to the Federal Reserve Banks the authority to undertake a follow-up corrective action against a U.S. branch or agency of a foreign bank, or against the parent foreign banking organization itself along with its U.S. offices. However, in our view, it is premature to consider such a modification to the FBO Program until we are sure that the program has been implemented on a consistent basis throughout the Federal Reserve System.

Another aspect of this Inspector General staff recommendation involves the suggested review of the Board's rules regarding the delegation of authority. In this regard, Inspector General staff has found room for improvements based on the fact that the current delegation rules concerning formal enforcement actions run, in some cases, to the Board's General Counsel and, in others, to the Federal Reserve Banks. While consistency may be desirable, it is our experience that there has been no confusion about the legal requirements set forth in the Board's regulations and no lack of consistency warranting the modification of the Board's delegation rules. Nonetheless, because Inspector General staff believes that it is important that an effort be made by Board staff to re-write the Board's delegation regulations and to ask the Board to consider the amendment of its existing delegation rules, we will work with our colleagues in the Legal Division to evaluate the Board's existing delegation of authority rules.

Inspector General staff also makes a recommendation regarding the delegation to the Federal Reserve Banks of some minor, and infrequent, aspects of the Board's enforcement activities--the modification and termination of written agreements. The modification of a written agreement is an activity that occurs perhaps once every three or four years, and requires minimal staff resources (approximately an hour or two at most). Because a proposal to modify a written agreement submitted by a Federal Reserve Bank involves the modification of a legally binding enforcement action, we believe that the staffs of the Enforcement Section and Legal Division need to continue to be involved with the review and approval process. Continuing to require this oversight is not burdensome to the staffs of the Federal Reserve Banks or the Board. On the other hand, the time may be right to consider the delegation to the Federal Reserve Banks of the termination of outstanding formal enforcement actions involving banking organizations (after consultation with Board staff), and we will work with the Legal Division to address this aspect of the recommendation.

Recommendation 3: We recommend that the Director of BS&R [Division of Banking Supervision and Regulation] update, consolidate, and complete enforcement policies, guidance, and procedures.

Inspector General staff basically addressed the two written "manuals" pertinent to the Federal Reserve's enforcement process--the Enforcement Section's internal procedures manual and a form book of useful examples of provisions used in routine corrective actions (referred to by Inspector General staff as the "Procedures Manual"). The Enforcement Section's internal procedures manual is used to assist Division staff in the processing of formal enforcement action recommendations and in other aspects of their functions, such as the preparation of interagency notification letters that are the sole responsibility of Board staff, and the preparation and distribution of press releases, again the responsibility of Board staff. The form book prepared by the Enforcement Section about three years ago contains all of the necessary form provisions relating to standard corrective actions. While it is three years old, the current form provisions are still very much acceptable to the staff of the Enforcement Section. However, consistent with the Inspector General staff's recommendation, we will work with the staff of the Legal Division and Federal Reserve Bank representatives to evaluate updating the form book and including additional enforcement action-related guidance in the book, such as guidance concerning automated databases, the review of Suspicious Activity Reports, and time frames for processing enforcement actions.

Recommendation 4: We recommend that the Director of BS&R [Division of Banking Supervision and Regulation] update program objectives relating to SAR [Suspicious Activity Report] data, revise staff responsibilities to eliminate duplication of effort, and issue guidance to the Reserve Banks on the use of SAR information.

Division staff is implementing two of the three parts of this recommendation. With respect to the issuance of guidance to the Federal Reserve Banks concerning the new SAR database, Division staff had already identified the utility of providing instructions regarding the use of the database by bank examiners for pre-examination scoping purposes and were including a new section covering the matter in the soon to be released new Bank Secrecy Act Examination Manual at the time of the program review. The new BSA Manual has been completed and is currently being printed; thus, this aspect of the recommendation has been fully implemented. Likewise, after the staff of the Inspector General pointed out to the Enforcement Section staff during the course of the program review that it had not updated its program objectives (i.e., the mission statement) to recognize the implementation of the new SAR database, and the elimination of the old criminal

referral form, we agreed to update the program objectives statement in conformity with this recommendation. In connection with the Division's recent reorganization, the Enforcement Section's mission statement was updated. With regard to the third aspect of this recommendation, which relates to the responsibilities of the Enforcement Section's Enforcement Assistant, we have reviewed the matter and, as described below, find that no reallocation of staff resources is appropriate at the present time.

Some background information about the new SAR process is helpful to an understanding of this recommendation and the comments about the process contained in the draft report.

In April 1985, the Federal Reserve along with the other federal financial institutions supervisory agencies began to require the banking organizations they supervised to report known or suspected criminal law violations to federal law enforcement authorities and to the banking agencies by using criminal referral forms. Each of the banking agencies adopted its own version of a criminal referral form, and required banks and other financial institutions to file copies of the form with several law enforcement agencies and regulators, depending on the nature of the suspected offense.

Contemporaneous with the development of the criminal referral form, the banking agencies started to work amongst themselves, and then with the FBI, on a central database that could collect information about criminal referrals for background check purposes. Pending the completion of a central repository, each of the federal banking agencies agreed to maintain an internal computer system to track the criminal referrals relating to the banking organizations that they supervised and to share pertinent information when requested. At the request of the Department of Justice, each of the banking agencies also agreed to review certain categories of criminal referrals and submit them to the Fraud Section of the Department of Justice's Criminal Division in Washington, D.C. in order to assist Justice's oversight responsibilities. These types of referrals, which were given the name "significant" by Justice, related to offenses involving more than \$200,000, a senior official, or systemic issues, and were physically sent by Enforcement Section staff to the Fraud Section for inclusion in that agency's significant criminal referral database.²

²The maintenance of a significant criminal referral database by the Fraud Section of Justice's Criminal Division was a mechanism for that office to keep track of the bank fraud-related activities of the U.S. Attorney's Offices. There are 94 U.S. Attorney's Offices in the United States. Each is headed by a U.S. Attorney who is appointed by the President. The operations

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From 1985 to April 1996, the staff of the Enforcement Section processed the thousands of criminal referral forms received from state member banks, bank holding companies, and nonbank subsidiaries of bank holding companies, and the U.S. branches and agencies of foreign banks. The processing included manually inputting information into a customized database by two members of the staff of the Enforcement Section and the forwarding of hundreds of "significant" criminal referral forms to Justice.³

After many years of work with our colleagues at the other federal banking agencies and in the law enforcement community, an entirely new criminal referral process was developed and put on line in April 1996. The new process involved the use of a Suspicious Activity Report (basically a new version of the prior criminal referral form) and a central computer database maintained by the Internal Revenue Service on behalf of Treasury's Financial Crimes Enforcement Network (FinCEN), the Federal Reserve and the other federal banking agencies. Banking organizations are now required to submit one form to one place in order to comply with their federal criminal referral and suspicious transaction reporting requirements. The new SAR database receives all criminal referrals on the new form, and provides a mechanism to deliver SAR data through computer modems or direct downloads to all federal law enforcement agencies responsible for investigating and prosecuting criminal offenses involving banking organizations (such as the FBI, U.S. Secret Service, Customs, and U.S. Attorney's Offices).⁴ The SAR database is nothing more than a

(...continued)

of the 94 U.S. Attorney's Offices are overseen by the Department of Justice, through its various divisions. Very much like the Board and its relationships with the Federal Reserve Banks, the U.S. Attorney's Offices generally operate independently with regard to the types of cases that they investigate and prosecute; but, they are subject to budget and policy oversight by the Department of Justice. For example, when bank fraud was the number one priority for Justice, the U.S. Attorney's Offices were provided with additional funds by Justice to hire new prosecutors to handle bank fraud cases; when, as a shift in policy, health care fraud became the first priority, those resources were redeployed to investigate and prosecute health care fraud.

³In 1995, Enforcement Section staff, for example, inputted information from about 12,000 criminal referral forms into the database.

⁴With the implementation of the SAR database, which can be directly accessed by Justice's Fraud Section, the staffs of the Board and the other federal banking agencies were relieved of

(continued...)

substitute for the old paper copies of the criminal referral form. The SAR database maintains SAR data electronically and allows the law enforcement community to review the data at computer stations, rather than reading hard copies of forms; and, as an ancillary benefit, it significantly simplifies and reduces banking organizations' reporting burdens.

The SAR database was not developed to be an analytical tool to focus law enforcement resources or identify trends in criminal offenses involving banking organizations. It is not a high tech, relational database capable of correlating diverse bits of information from SARs to produce cogent analyses of bank crimes. In essence, the SAR database is basically a delivery system that is capable of handling only rudimentary data searches, such as routine background checks (i.e., to determine if a SAR was filed on a certain individual). Over the past year, considerable efforts were undertaken by the staffs of the Board, the four other banking agencies, and FinCEN (the agencies who own and are responsible for the database) to explore the possibility of expanding the analytical capabilities of the SAR database. We found that with the expenditure of several hundred thousand dollars it is possible that the rudimentary SAR database can be transformed into a more sophisticated analytical tool. However, the OCC refused to consider the funding of an upgrade of the IRS's computer system that houses the SAR database, and FDIC and OTS staff advised us that their agencies faced funding issues due to their downsizing efforts. Notwithstanding the positions taken by the OCC, FDIC, and OTS staffs and because the staff of the Inspector General expresses the view in the draft report that the SAR database could be used by Board and the Federal Reserve Bank staffs for bank supervisory purposes, we will continue to work with our colleagues at the other federal banking agencies and FinCEN to try to upgrade the capabilities of the SAR database and to see if useful bank supervision-related information can be obtained through more sophisticated analysis of SAR data.

Also with regard to the comments in the draft report about the use of the SAR database to identify safety and soundness issues associated with particular banking organizations, it should be pointed out that for the past 11 years (between 1985 and April 1996) a review of the paper copies of criminal referral forms filed by state member banks and other financial institutions supervised by the Federal Reserve could not be used to identify any particular internal deficiencies or significant safety or

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their responsibilities to cull out "significant" referrals and send them by mail to Justice. Thus, the concept of a "significant" criminal referral expired with the start-up of the SAR database.

soundness concerns.⁵ Likewise, a review of SARs in the SAR database (merely an electronic substitute for the review of paper forms) cannot help in the identification of deficiencies at particular banking organizations. Every large banking organization in this country files many hundreds of SARs every year (sometimes 5,000 or more); this does not mean that their controls are weak or there are vulnerabilities that need to be addressed or investigated. Tellers simply steal money, borrowers submit false information, customers attempt to structure transactions to avoid currency reporting requirements, and individuals pass bad checks. The fact that this happens hundreds of times at some banking organizations neither indicates that there are serious internal control deficiencies, nor demonstrates that the bank is operating in an unsafe or unsound manner, is in imminent danger of failing, or is suffering some other problem warranting supervisory action.

The final matter to be discussed in connection with this recommendation is the Inspector General staff's finding that the work of a member of the staff of the Enforcement Section, the Enforcement Assistant, duplicates the efforts that the Federal Reserve Banks take to review SARs and that the resources of the Division of Banking Supervision and Regulation should be adjusted to address this redundancy. In response to this recommendation, we have carefully reviewed the activities of the Enforcement Assistant and concluded that she plays an important role in the Federal Reserve's efforts to identify activities warranting attention by enforcement officials. The Enforcement Assistant reviews SARs in the SAR database on a daily basis, among her other duties and responsibilities, in order to identify for the management of the Enforcement and Special Investigations Sections any SARs relating to senior insiders or involving unusually large potential losses. While each Federal Reserve Bank also reviews SARs involving banking organizations in its District, we believe that the back-up provided by the Enforcement Assistant is essential because she provides consistency within the Federal Reserve System due to her ability to evaluate the importance of certain suspicious activities and to compare wrongdoing across a broader spectrum of financial institutions supervised by the Federal Reserve, rather than from the perspective of one Federal Reserve Bank. Moreover, on account of the Enforcement Assistant's daily reviews of the SAR database, staff is able to review very promptly any noteworthy SARs she identified and, with Board staff's high level of experience and expertise (which in most cases is significantly greater than exists at the Federal Reserve Banks), we can react quickly where necessary.

⁵With the possible exception of the Daiwa and BCCI matters, the staff of the Enforcement Section has never seen a criminal referral form or SAR that reported a suspected or known federal criminal law violation that had a material effect on the reporting institution or that described an incident that potentially had systemic implications for the U.S. banking system.

Other Matters

The draft report includes some commentary regarding the Division of Banking Supervision and Regulation's then proposed reorganization plan; however, none of the four recommendations made by the staff of the Inspector General in its draft report included any specific suggestions or directions concerning management or structural changes. Rather, the draft report included the comment that the Division of Banking Supervision and Regulation's reorganization proposal should provide the Board with an opportunity to "address enforcement-related roles and responsibilities and ensure that the [D]ivision's new structure encompasses all aspects of the enforcement function, including determining resource requirements, establishing program guidance, and providing program oversight (emphasis added)".

The Division's reorganization plan was approved by the Board on September 15, 1997. During the course of our development of the appropriate structure needed for the Division to carry out its bank supervisory responsibilities and our discussions about restructuring with the members of our Division's bank supervision oversight committee and other Board members, we believed that our Division's reorganization would provide a framework for improving coordination and communications within the Division. The consolidation of policy-related matters under one senior officer, domestic and foreign supervision under another senior officer, and applications and enforcement-related matters under a third was designed to improve the allocation of resources and help produce important synergies. In our reorganization plan, we sought to ensure that the senior management and staff of the Enforcement Section--working closely with the officials and staffs of the Division's new policy and supervision sections--continues to play a crucial coordination role in the development, review, approval, and implementation of enforcement actions. Division management took this action in recognition of the fact that enforcement activities are collaborative efforts undertaken collectively by the Federal Reserve Banks, several components of the Board's staff, including the Legal Division and the Division of Consumer and Community Affairs, and, in many instances, state bank supervisory authorities.

cc: Mr. Schemering
Mr. Biern
Mr. Small
Mr. Mattingly
Mr. Ashton

Appendix 4 - Principal Contributors To This Report

- ▶ Nancy Perkins, Senior Auditor and Auditor-in-Charge
- ▶ William Mitchell, Auditor
- ▶ Michael Green, Senior Auditor
- ▶ David McCue, Auditor
- ▶ Gail Pinkepank, Senior Auditor
- ▶ Vitus Ukwuoma, Auditor
- ▶ Karen Wiseman, Auditor
- ▶ Patricia Kelley, Audit Manager
- ▶ Harry Jorgenson, Counsel to the Inspector General
- ▶ Barry Snyder, Assistant Inspector General for Audits